NOT FOR PUBLICATION

UNITED STATES BANKRUPTCY COURT

EASTERN DISTRICT OF WASHINGTON

In Re:	
SMLP, a Washington State Limited Partnership,	No. 97-06464-W1R
Debtor.	MEMORANDUM DECISION RE: U.S. TRUSTEE'S MOTION FOR SUMMARY JUDGMENT DISALLOWING FEES AND ORDERING DISGORGEMENT

THIS MATTER came on for hearing before the Honorable Patricia C. Williams on August 7, 2000 upon the U.S. Trustee's Motion for Summary Judgment Disallowing Fees and Ordering Disgorgement. The debtor was represented by Dan O'Rourke and Kevin O'Rourke. Robert Miller, the Assistant U.S. Trustee, was also present. The court reviewed the files and records herein, heard argument of counsel and was fully advised in the premises. The court now enters its Memorandum Decision.

I.

FACTS

Debtor was a limited liability partnership which operated a gambling casino with related food and beverage service. The Chapter 11 proceeding was filed November 26, 1997 and was converted to a Chapter 7 on November 24, 1998. The Chapter 7 Trustee has sufficient funds on hand to pay the administrative expenses in the Chapter 7. Mr. O'Rourke was the attorney for the debtor-in-

possession and has requested approval of his professional fees for the proceeding. The U.S. Trustee has objected and argues that the court should deny the request to approve the fees and require Mr. O'Rourke to disgorge all sums held in his trust account for failure to disclose as required by F.R.B.P. 2016.

According to the Application for approval of the professional fees, Mr. O'Rourke holds $23,000.00 in his trust account for application to approved fees. The application seeks approval of fees in the amount of $25,903.00 plus costs of $1,875.45 for a total of $27,778.45.[1]

The source and dates of the deposits into the trust account are as follows:

Date	**Amount**	**Source**
11/25/97 (pre-petition)	$7,500.00	Debtor
05/14/98	$3,750.00	Galaxy Gaming
06/01/98	$1,000.00	Debtor
06/12/98	$1,750.00	Debtor
10/15/98	$6,000.00	Galaxy Gaming
11/12/98	$3,000.00	Debtor

On December 15, 1997, Mr. O'Rourke requested that the court approve his employment by the bankruptcy estate and an order approving that employment was entered on February 12, 1998. That Application for employment and the Attorney Statement of Compensation filed November 26, 1997 disclosed the payment of the

[1]This does not include the filing fee of $800 paid by counsel at the time of filing from the trust account nor $2,000 paid by the debtor in February, 1997 for pre-petition services. These payments were timely disclosed and are not in dispute.

$7,500.00 which was the only deposit then held. The Application also disclosed that the sum was held in trust for application to any approved fees. Not until August 9, 1999 did Mr. O'Rourke file his request for approval of professional fees. It was that Application which first disclosed the post-petition amounts received from the debtor and Galaxy Gaming.

F.R.B.P. 2016 requires the attorney for the debtor to file within 15 days of the order for relief a statement regarding the compensation the debtor has paid or agreed to pay for the professional services and sources of the compensation. That statement was timely filed on November 26, 1997. F.R.B.P. 2016 also requires a supplemental statement be filed and served on the U.S. Trustee within 15 days of any later payment or agreement to pay. No supplemental statement was filed.

II.

ISSUES

1. Did the debtor's counsel have a duty to disclose under F.R.B.P. 2016?

2. If a violation occurred, is denial of the award of fees and disgorgement of funds held in the trust account the proper remedy?

3. If disgorgement is required, should it include both pre-petition amounts and post-petition amounts?

III.

DISCUSSION

1. Was there a duty to disclose under F.R.B.P. 2016?

The debtor's counsel argues that he had no duty to file a supplemental disclosure statement as, under state law, he had a

possessory security interest in the funds held. R.C.W. 60.40.010. Even if there were the duty to disclose, Mr. O'Rourke argues that disgorgement is inappropriate due to his status as a secured creditor with rights in the funds. *United States Trustee v. Garvey, Schubert & Barer (In re Century Cleaning Servs.)*, 215 B.R. 18 (9th Cir. Or. BAP 1997), based on Oregon statutes, held an attorney had a security interest in funds held in a trust account, but was reversed on other grounds at 195 F.3d 1053 (9th Cir. 1999). Even assuming such a statutory lien existed under Washington law, this does not relieve the attorney from complying with the mandates of the Code as they relate to professional fees. *Shapiro Buchman LLP v. Gore Bros. (In re Monument Auto Retail)*, 226 B.R. 219 (9th Cir. Cal. BAP 1998). If the attorney fails to comply with those mandates, including violation of the duty to disclose, the attorney is not allowed to retain the funds. The existence of a possessory lien would not deprive the court of its authority to require disgorgement of the funds as a sanction for failure to comply with the Code. If the court determines that the attorney should not have fees approved or is not entitled to payment of all fees sought, there is no underlying obligation to be secured with the funds.

Debtor's counsel next argues that no supplemental statement was required in this case as the deposits into the trust account were not "payments" but a security retainer. As such, they were only to secure eventual payment after the legal services had been provided and the requested fees approved by the court. Therefore, counsel argues they themselves were not "payments."

It is not disputed that the $7,500.00 pre-petition deposit and

later deposits were security retainers. *In re McDonald Bros. Constr., Inc.*, 114 B.R. 989 (Bankr. N.D. Ill. 1990) contains an excellent analysis of the three types of retainers: 1) the classic retainer in which a sum of money is paid to insure an attorney's availability over a period of time and the attorney is entitled to the money regardless of whether any services are actually provided; 2) the advance payment retainer in which ownership of the funds passes to the attorney at the time of payment in exchange for the attorney's commitment to provide certain legal services; and 3) a security retainer. A security retainer is not a present payment for future services. Rather, the funds remain property of the client until the attorney performs the service and funds are then applied to the charges for the actual services provided. Typically, funds are deposited into the law firm's trust account and as fees are actually earned and billed, the funds are withdrawn from the trust account and applied to the bill. Any funds remaining after completion of the services are returned to the client.

A security retainer is that most commonly encountered in bankruptcy proceedings. In the bankruptcy context such security retainers remain property of the bankruptcy estate and are subject to distribution from the trust account only after compliance with the provisions of the Code regarding compensation of professionals. *In re McDonald Bros. Constr., Inc., supra*, and *SEC v. Interlink Data Network*, 77 F.3d 1201 (9th Cir. Cal. 1996).

The argument that security retainers are not "payments" requires a contorted reading of F.R.B.P. 2016 inconsistent with the purpose of both § 329 and F.R.B.P. 2016. The purpose of those

provisions is to reveal to the court and interested parties all sources of compensation, either actual or anticipated. Placing cash into an attorney trust account removes it beyond the reach of the debtor and the debtor's creditors, but it still remains property of the bankruptcy estate. For purposes of disclosure under § 329, it is just as much a payment as placing the cash into the law firm's general account. The payments which must be disclosed are those for "services rendered or to be rendered in contemplation of or in connection with the case." Such language certainly includes security retainers.[2]

Debtor's counsel timely and fully disclosed the receipt of the pre-petition funds. However, the express language of F.R.B.P. 2016 requires disclosure of the receipt of the post-petition funds within 15 days of their receipt. Debtor's counsel argues that as the principal of the debtor revealed these post-petition payments in a July 13, 1998 2004 exam, disclosure occurred. Assuming the substance of the testimony did describe those transactions, the disclosure was untimely. F.R.B.P. 2016 requires disclosure to be served on the U.S. Trustee and filed with the court which makes the information available to all interested parties. Most importantly, the duty to disclose is placed on the debtor's counsel.

Debtor's counsel's failure to file and serve a written supplemental disclosure violates F.R.B.P. 2016. The appropriate remedy for that violation must then be determined.

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[2]Both § 329 and F.R.B.P. 2016 use the term "agreements." Even if one accepted that these post-petition deposits were not "payments," they certainly were part of some agreement for compensation. Thus, they are subject to disclosure as an "agreement."

2. **Is denial of the requested fees and disgorgement of the security retainer the appropriate remedy?**

The facts of each particular case must be examined to determine the appropriate remedy. Failure to file supplemental disclosure statements when post-petition deposits have been made to law firm trust accounts has resulted in the denial of all fees and a return of all funds. *Law Offices of Nicholas A. Franke v. Tiffany (In re Lewis),* 113 F.3d 1040 (9th Cir. Cal. 1997). The Ninth Circuit in that decision held that bankruptcy courts ". . . have broad and inherent authority to deny any and all compensation when an attorney fails to meet the requirements of these (disclosure) provisions." *In re Lewis, supra,* at p. 1044. In doing so, the bankruptcy court is exercising its discretion.

The facts in the *Lewis* case were egregious. In January, 1993, the attorney filed a statement of compensation which was false. It indicated that the attorney had received $20,000.00 and the debtor had agreed to pay an additional $20,000.00. In July of 1993, another false statement was filed which indicated that the attorney had received $40,000.00 pre-petition as a security retainer. The U.S. Trustee raised several questions and, after a hearing, the court required the attorney to provide an accounting of all funds received from the debtor. In reality, the attorney had received $10,000.00 pre-petition and an additional $30,000.00 post-petition. The attorney had deliberately delayed several months in filing an application to approve the fees in order to collect the post-petition payments. The Bankruptcy Court found that his actions were an attempt to avoid the Code's requirement concerning disclosure of post-petition retainers. The conduct was a "shocking

disregard" of the Code's requirements and was a willful violation of both § 329 and F.R.B.P. 2016. For that reason, the court allowed no compensation at all and required disgorgement of all funds received.

Clearly, disgorgement is an appropriate remedy and the court, in its exercise of discretion, must determine to what extent the allowance of fees should be denied and the funds held in the trust account be disgorged.

3. Should disgorgement include all pre-petition and post-petition amounts?

a) Disgorgement of pre-petition payments.

The requirement to file a timely supplemental disclosure under F.R.B.P. 2016 is not ambiguous. The requirement is mandatory. Even negligent or inadvertent failure to disclose violates the rule and can lead to a forfeiture of all fees. *Peugeot v. United States Trustee (In re Crayton)*, 192 B.R. 970 (9th Cir. Cal. BAP 1996). Disclosure requirements are to be applied strictly. F.R.B.P. 2016's literal requirements are to be enforced even though the result of its application and enforcement is harsh. *Neben & Starrett v. Chartwell Fin. Corp. (In re Park-Helena Corp.)*, 63 F.3d 877 (9th Cir. Cal. 1995), *cert. denied,* 516 U.S. 1049 (1996). However, absent an egregious situation such as in *Lewis* or an indication of willful rather than negligent failure to disclose, denial of all fees may be too harsh a penalty. *In re Boh! Ristorante, Inc.*, 99 B.R. 971 (9th Cir. Cal. BAP 1989).

Any failure to file a supplemental statement of disclosure should result in a denial of some portion of fees and a disgorgement of the same. The requirements of F.R.B.P. 2016 are

mandatory and are to be enforced. Enforcement is part of the court's duty to ensure that all professional fees incurred for services benefitting the bankruptcy estate meet the requirements of the Code. Disclosure of post-petition security retainers is one device the framers of the Code and Rules developed to aid the court in performing its duty as well as to aid the United States Trustee in performing his duty to monitor compensation in Chapter 11 proceedings. It is also a device to provide information to those parties having an interest in the proceeding.

Having concluded that a failure to file supplemental disclosures will result in a penalty and can serve as a basis for denying all fees, the court must then determine the extent of the penalty appropriate in this proceeding.

In the present situation, no false Statement of Compensation was filed. The Statement of Compensation and the Application for Employment accurately disclose the facts as they then existed, i.e. the pre-petition payment of the $7,500.00 into the trust account. The Application for approval of fees revealed the post-petition payments, but it was not filed until August 9, 1999, approximately nine months after receipt of the last post-petition payment. Although the delay causes the court some concern, there is no indication that the lapse in time was intended to circumvent the requirements of disclosure. These facts do not justify depriving the debtor's counsel of the pre-petition retainer of $7,500.00. Compensation in that amount is certainly reasonable and otherwise meets the requirements of § 330 and is approved. Debtor's counsel may pay himself that amount from the funds held in the trust account.

b) Disgorgement of post-petition payments.

The first post-petition payment at issue was made on May 14, 1998 by Galaxy Gaming. The relationship of this third-party to the debtor is not known. The file reflects that approximately one week after commencement of the proceeding, the debtor filed a Motion to Assume a Lease dated the day before filing. Under that lease, the debtor leased its real and personal property to Zephyr Cove Capital, a Nevada L.L.C., the manager of which was Galaxy Gaming. Mr. Saucier, the individual who managed the debtor's operations during this proceeding, had signed the Lease both as president of the general partner of the debtor and as president of Galaxy Gaming. That lease was never assumed.

At the time of this payment, the file reflects that the Washington State Attorney General had filed a Motion to Lift the Automatic Stay to allow a state administrative proceeding to revoke the debtor's liquor license to proceed. At a hearing on May 5, 1998, the Motion was set for final hearing on June 10, 1998. Also pending was a Motion to Dismiss or Convert by the U.S. Trustee as the debtor had neither filed operating statements nor paid U.S. Trustee fees. The State of Washington also had filed a Motion to Dismiss or Convert for failure to pay post-petition taxes. By the time of the debtor's next payment to its counsel of $1,000.00 on June 1, 1998, the City of Spokane had also filed a Motion to Convert for failure to pay post-petition city gambling taxes. During the summer of 1998, there were references by counsel to the possibility of improper entanglement of the financial affairs of various entities owned or controlled by Mr. Saucier. No evidence was ever introduced on that issue and the issue never directly

addressed.

The debtor's June 12, 1998 payment of $1,750.00 was made after the stay had been lifted to allow the license revocation proceeding to go forward, but before the preliminary hearing on June 15, 1998 on the various Motions to Dismiss or Convert. At that hearing, the IRS indicated it also desired to file a Motion to Convert or Dismiss for failure to pay post-petition taxes. As there were disputed issues of fact, final hearing on the various Motions was scheduled for July 13, 1998.

At that hearing, testimony indicated that all post-petition returns had by then been filed and most taxes referenced in the motions paid, but that there was some dispute as to the remaining amount due or taxes accruing after the motions were filed. Operating statements were current, but showed significant losses and significant additional post-petition taxes coming due shortly after the hearing. The court indicated there were serious doubts about the debtor's ability to reorganize particularly in light of the continuing losses. The debtor was required to meet certain requirements such as filing all post-petition tax returns and paying post-petition taxes pending a later hearing scheduled for September 4, 1998. By the hearing on September 4, 1998, the debtor had filed amended operating statements which significantly reduced the amount of post-petition losses and had made significant post-petition tax payments. The debtor was required to provide additional financial information to the interested parties and again required to meet certain conditions such as continuing to pay post-petition taxes. The final hearing on the various motions was scheduled for November 23, 1998.

On October 15, 1998, the debtor's counsel received a payment of $6,000.00 from Galaxy Gaming and on November 12, 1998, a payment of $3,000.00 from the debtor. By the latter date, the debtor had filed a Disclosure Statement and Plan and the City had filed pleadings indicating that the debtor had failed to pay post-petition taxes as ordered in September. Several objections to the Disclosure Statement and Plan were filed. At the hearing on November 24, 1998, the court converted the case to a Chapter 7 as the debtor had failed to meet all the requirements previously set by the court.

Application of these rather lengthy facts to the question of disgorgement must be considered in light of the purpose of the requirement for supplemental disclosure. A debtor which places property of the estate into the hands of its attorney as a security retainer has in reality placed those funds, at least temporarily, beyond the reach of its creditors. The funds are no longer available to pay ordinary operating expenses. Most Chapter 11 debtors are in dire financial straights and utterly dependent upon their own counsel to guide them through the reorganization process. It is for these reasons that the Code requires bankruptcy courts and the U.S. Trustee to monitor Chapter 11 debtors' relationship with its professionals. *Boh! Ristorante, Inc., supra.*

In the situation of security retainers paid by third parties, disclosure is necessary to address the possibility of any conflict of interest on the part of the debtor's counsel. Such payments may also be relevant to questions concerning the debtor's relationship with insiders and subsidiary or sister corporations.

In this particular case, the debtor's counsel received

$5,750.00 from the debtor at times when it was apparent that the debtor was not meeting its post-petition obligations such as U.S. Trustee fees and taxes. Operating statements indicated extremely large losses. It is entirely possible that due to the relatively small amount of funds received from the debtor, the U.S. Trustee would not have objected if he had known. It is quite possible that even if he had objected, the court would have allowed the amounts to be paid. However, the question is disclosure, not whether the security retainers would have been allowed. The disclosure certainly should have occurred.

The court is unaware of any discovery or discussions among counsel occurring in 1998 regarding the financial relationship among the debtor and other entities owned or controlled by Mr. Saucier. The lease assumption situation and occasional comments of counsel in court indicated some possibility that this could become an issue in the proceeding. Under such circumstances, the security retainer received from Galaxy Gaming becomes an important piece of information. Again, it is not a question whether the U.S. Trustee would have objected to such payments or whether knowledge of the payments would have precipitated questions being raised regarding the relationship of that entity to the debtor. The question is disclosure, not whether the disclosure would have had any effect on the bankruptcy proceeding. Disclosure should have occurred.

IV.

CONCLUSION

F.R.B.P. 2016 requires disclosure of all payments and failure to disclose any amount of payment from any source subjects counsel

to the risk of disgorging all payments received, disclosed or not. In this particular case, there is no evidence that failure to disclose post-petition payments was willful rather than inadvertent or negligent, and pre-petition payments were disclosed timely. Consequently, it would be inappropriate to require disgorgement of pre-petition payments. As to the post-petition payments, ordinarily the failure to disclose would result in disgorgement of all post-petition fees. However, there is one vital mitigating factor not yet addressed.

It has unfortunately been the practice in this District for most debtor's counsel to ignore F.R.B.P. 2016's duty to supplement statements of compensation when funds are placed into a trust account post-petition. Filing of supplemental disclosure statements has been rare. It would not be fair to Mr. O'Rourke to impose the full penalty as Mr. O'Rourke has unfortunately followed a commonly accepted practice in this District. The practice of disregarding supplemental disclosure requirements under F.R.B.P. 2016 must change, and if it does not, counsel will be required to disgorge all post-petition security retainers and, in appropriate cases, pre-petition payments. In this case of first impression in the District, the penalty should be modified. After balancing the clear unambiguous language of the Rule and the circumstances of this particular proceeding and the mitigating factor, disgorgement of $5,000.00 will be required as a penalty for failure to timely disclose the post-petition payments.

Although the amount sought as compensation is reasonable and otherwise would be allowable under 11 U.S.C. § 330, $5,000.00 of the post-petition payments of $15,500.00 should be disgorged for

failure to comply with the supplemental disclosure requirements of F.R.B.P. 2016 and the allowed fees reduced by that amount. That $5,000.00 is to be paid to the Chapter 7 Trustee. Both the U.S. Trustee and the debtor raised the issue of who should receive the post-petition funds paid by Galaxy Gaming if in fact they are required to be disgorged. That issue is not currently before the court and will not be addressed at this time. The funds should be disgorged to the Chapter 7 Trustee who will then propose a distribution of those funds to the creditors in the Chapter 7 proceeding or to the debtor or to Galaxy Gaming or to whomever he deems appropriate. All interested parties will have an opportunity to object to that proposed distribution and argue whatever issues are then relevant. Debtor's counsel may pay the allowed costs of $1,875.45 and allowed fees with the remaining security retainer now held in trust.

The Clerk of the Court is directed to file this Memorandum Decision and provide copies to counsel.

DATED this 16th day of October, 2000.

PATRICIA C. WILLIAMS, Bankruptcy Judge